

Agenda Date: December 14, 2005  
Item Number: A2

**Docket: UT-051838**

Company Name: Qwest Corporation  
United Telephone Company of the Northwest

Staff: Glenn Blackmon, Director of Regulatory Services

### **Recommendation**

Issue an order in Docket UT-051838 initiating competitive classification of the residential packaged services of Qwest Corporation and United Telephone Company of the Northwest to become effective on January 31, 2006.

### **Summary**

Staff recommends that the Commission issue an order initiating competitive classification of the residential packaged services of the incumbent local exchange companies listed above, to become effective on January 31, 2006.

We provide evidence below that the services meet the statutory requirements for competitive classification and that competitive classification will provide additional protections to consumers and competitors of these services.

The recommended action to initiate competitive classification would not be a final determination by the Commission that the services are competitive. The Commission would decide at the January 24, 2006, open meeting whether to allow the competitive classification to take effect or to suspend the case and conduct a formal hearing.

### **Discussion**

#### **A. Background**

Staff is requesting that the UTC initiate competitive classification of the bundled or packaged services that are now being offered as regulated services by two incumbent local exchange companies (ILECs): Qwest Corporation and United Telephone

Company of the Northwest (dba Sprint).<sup>1</sup> Initiating the classification process will provide the Commission with the opportunity in January 2006 to make a determination either to allow the competitive classification to take effect or to suspend the case and set it for hearing.

The customers purchasing these packages have ready alternatives. In particular, the customers can obtain the same services individually from the same company at prices subject to regulation by the UTC. Regulation of the package price is not necessary to protect customers from unreasonable rates, and treatment of these packages as regulated services deprives customers and competitors of statutory protections that apply only to services classified as competitive.

State law allows the UTC to classify as competitive the services of a regulated telecommunications company, if the company does not have a significant captive customer base for those services.<sup>2</sup> The law allows the UTC to take this action either at the request of the regulated company or, as in this case, on the Commission's own motion.<sup>3</sup>

There are two principal effects when the UTC classifies a service as competitive:

(1) More pricing flexibility. The company offering the service has more freedom to set and modify the prices and other terms at which it offers the service. The company can raise or lower the price of a competitive service on 10 days' notice to

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<sup>1</sup> Staff intends to request that the UTC initiate competitive classification of the residential bundles of Verizon Northwest, Inc. However, due to scheduling conflicts Staff was not able to discuss this proposed action with Verizon in time to include it on this agenda. This memorandum and its attachments present evidence on Verizon's residential bundles in order to provide a more complete picture of ILEC offerings.

<sup>2</sup> RCW 80.36.330 authorizes the Commission to "classify a telecommunications service provided by a telecommunications company as a competitive telecommunications service" if it finds that the service is "subject to effective competition." The statute defines "effective competition" to mean that "customers of the service have reasonably available alternatives and that the service is not provided to a significant captive customer base." In determining whether a particular service is a competitive service, the statute requires that the Commission consider, among other factors:

1. the number and size of alternative providers of services;
2. the extent to which services are available from alternate providers in the relevant market;
3. the ability of alternative providers to make functionally equivalent or substitute services readily available at competitive rates, terms, and conditions; and
4. other indicators of market power, which may include market share, growth in market share, ease of entry, and the affiliation of providers of services.

<sup>3</sup> The UTC has initiated competitive classification of ILEC services on its own motion at least two times, in Docket UT-970767 (GTE Northwest toll services) and in Docket UT-040172 (Verizon Northwest out-of-area services).

the UTC, compared to the 30 days' notice required for a service offered by tariff.<sup>4</sup> A company increasing the price of a regulated service is expected to demonstrate that the increase is reasonable, but no such demonstration is required before increasing the price of a competitive service. Also, a company can use contract pricing for competitive services without obtaining UTC approval for each contract, where UTC approval is required for contract pricing of regulated services.<sup>5</sup>

(2) Application of specific competition-related consumer protection laws. The company is subject to various telecom-specific and general business laws that are intended to protect the consumers of competitive services, to protect other businesses from anti-competitive actions, and to protect the company's remaining customers from improper subsidies or practices.

The UTC has actively used the competitive classification process to manage the level of regulation that it applies to telecommunications services. It applies traditional rate regulation to protect customers from excessive pricing when customers do not have a choice of providers or service, but it also removes regulation where there is no need for that protection. The UTC has recognized that it would be a mistake to maintain rate regulation where there is no ability to charge excessive prices, because doing so deprives customers and competitors of the safeguards that the Legislature intended to apply where a company is offering a competitive service.

B. Data on Incumbent Local Exchange Company Subscribers

Incumbent local exchange companies have faced increasing competition in recent years for those residential customers at the upper end of the market, i.e., those who purchase more services than the basic flat-rate dial tone. In two years, from 2002 to 2004, the three companies lost 6.8% of their residential primary lines in this state:

<b>Washington Residential Primary Lines</b>			
	<u>2002</u>	<u>2004</u>	<u>Change</u>
Qwest	1,305,846	1,201,443	-8.0%
Verizon	536,419	515,094	-4.0%
Sprint/United	<u>47,952</u>	<u>45,600</u>	<u>-4.9%</u>
Total	1,890,217	1,762,137	-6.8%

Source: FCC ARMIS Report 43-08.

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<sup>4</sup> RCW 80.36.110.

<sup>5</sup> WAC 480-80-142, WAC 480-80-241.

Primary lines are defined in the FCC reporting to exclude additional lines at a residence, so the loss of lines reported above does not include the effect of customers who cancelled their additional lines. Moreover, this loss of lines is particularly striking because, while the number of ILEC primary lines decreased by 128,000 during this period, the overall number of households in Washington with telephone service increased by about 50,000, from 2.26 million households to 2.31 million.<sup>6</sup> Including those 50,000 households as potential ILEC customers, the shrinkage in ILEC residential lines from 2002 to 2004 is approximately 9 percent.

Even the 9 percent market loss understates the extent to which ILECs have lost the customers to whom residential bundles are marketed, because the market loss figure includes all residential customers, including the customers at the lower end of the residential market where there are virtually no alternatives to the ILEC for service. Qwest reported in its third quarter 2005 financial results that half of its residential customers do not purchase any additional features or bundles. If a similar proportion holds for other ILECs, then the market loss among those customers who purchase features, i.e., the high end of the market, is approximately 18 percent.

### C. Description of ILEC Bundled Offerings

Attachment 1 provides information on the ILEC residential packages that Staff is proposing to classify as competitive. The attachment includes the description of the bundles that each company offers customers on its web site, along with the relevant pages from the company's Washington intrastate tariff.

The ILECs have responded to competition for their high-revenue residential customers by offering bundles, in which several services are offered jointly at a discount from the stand-alone or "a la carte" prices. The use of bundles enables the company to maintain its high markup on individual features, such as call waiting or caller ID, while still offering a discount to those customers who are willing to purchase multiple features. The companies also believe that customers who subscribe to bundles are less likely to switch providers.

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<sup>6</sup> Using federal government statistics, Staff estimates that 2.26 million Washington state households (96.4 percent of 2.34 million total households) had telephone service in 2002 and 2.31 million households (95.5 percent of 2.416 million total households) had telephone service in 2004. Sources: <http://factfinder.census.gov>; [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-262084A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-262084A1.pdf).

Attachment 2 illustrates the relationship between the ILEC packages and the stand-alone services. Qwest offers its Qwest Choice Home package for \$29.99 per month; it includes the dial tone service and the customer's choice of three features. The same services would cost \$37.32 if purchased separately. In addition to the discount on monthly charges, the ILECs typically discount the one-time charges for adding or changing services.

ILECs also offer long-distance services within the bundles, effectively providing a discount on toll services. ILECs are offering these bundles in response to significant competitive pressure from wireless companies, which have adopted a pricing structure in which there is no different in price between local and long-distance calls. An example is the Qwest Choice Unlimited plan, which is in Attachment 1. It is offered both as a stand-alone toll package at \$20 per month or as an addition to a Qwest local bundle at \$15 per month. A customer who chooses the Qwest Choice Home bundle and the Qwest Choice Unlimited toll plan would pay \$44.99 per month for a combination of local services, features, and toll service that is very similar, both in price and service characteristics, to wireless service.<sup>7</sup>

#### D. Alternatives to ILEC Residential Packaged Services

Customers who purchase ILEC residential packaged services have alternatives that are comparable in price and features. These alternatives are broadly grouped into two categories: packages provided by other telecommunications providers and the stand-alone services of offered by the ILEC itself at regulated prices.

##### 1. Comparable Services Offered by Other Telecommunications Companies

ILECs such as Qwest and Sprint face competition for high-end residential customers wireless companies, Internet companies, and cable providers. Competitive local exchange companies also offer some high-end residential alternatives, such as the MCI Neighborhood plan. Attachment 3 includes examples of packages offered by other providers.

In some cases, the alternative provider is an affiliate of the ILEC. For example, Verizon's affiliates offer wireless service and Internet telephone service, and Verizon is in the process of acquiring MCI. Sprint's affiliate offers wireless service (though Sprint

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<sup>7</sup> Each service has distinctive characteristics, the Qwest service offering unlimited minutes with no mobility and the wireless service offering a limited number of minutes and mobility.

has proposed to separate its wireline and wireless businesses). Even in those examples where the alternative provider is an affiliate of the ILEC, that alternative service can help constrain the prices of the ILEC, because the parent companies are offering wireless and Internet telephone services in competition with unaffiliated wireless and Internet telephone providers.

An ILEC customer spending \$50 to \$70 per month for local services, features, and long-distance services can obtain a similar set of services at a similar price from these other companies. In some cases the services are not identical, and not every alternative is available to every ILEC residential customer. However, these alternative providers collectively are viewed by customers as comparable substitutes for ILEC services, as evidenced by the rapid recent loss of ILEC primary line customers.

## 2. Tariffed ILEC Services

The key element of Staff's argument for competitive classification of ILEC bundles is, however, not the alternative providers discussed above but rather the fact that all of the telecommunications services available in the bundle are also available at regulated, stand-alone prices in the ILEC's local exchange tariff. No customer is required to purchase the bundle to obtain the services in the bundle, because those services are all available individually at tariffed prices.

As illustrated in Attachments 1 and 2, the only difference between the ILEC's bundle and the included services purchased on a stand-alone basis is the price. The individual services are individually available at prices regulated by the UTC, individually classified as competitive, or unregulated services. The availability of individual services at regulated prices establishes an upper bound on the price that the ILEC can sustain for its bundle. This tariffed ceiling price could be substantially higher than the bundled price, but there should be no argument about whether that tariffed ceiling price is fair, just, and reasonable, given that it is composed of rates that are under the control of the UTC. Any concern about the tariffed rates could, at any time, be addressed through the formal complaint process.

This is not the classic example of competition. However, it is not unusual for the UTC to rely on an ILEC's regulated services as the basis for competitive classification of other services of the same ILEC. The UTC classified local toll services of GTE and U S WEST based largely on the ability of competitors to use those ILECs own network by paying regulated exchange access rates. Dockets UT-970767 and UT-990021. The UTC also

classified business services of Qwest based largely on the ability of competitors to use Qwest's own network by paying regulated rates for unbundled network elements (UNEs). Docket UT-000883, Docket UT-030614 (para. 96: "The Commission rejects arguments that UNE-P or UNE-L are not price constraining competition.")

With tariffed prices as the constraint on pricing, the ultimate effect of classifying ILEC bundles as competitive is that each ILEC would have the flexibility to decide on the size of the discount that it wishes to offer. It is reasonable to expect that the decision on the size of the discount will be affected by the constraints of the market and would be expected to increase or decrease with the level of competition that the ILEC faces. At the extreme, where the ILEC faced little or no competition from other providers, it faces competition from its own tariffed services, which are perfect substitutes for the bundle and are offered at prices that, by law, are fair, just, and reasonable.

#### E. Additional Consumer and Competitive Protections

This section discusses the benefits that result from competitive classification of the ILEC's residential packaged services. We include this information because we recognize that competitive classification is a discretionary decision for the Commission. The law sets standards that must be met before the Commission can classify a service as competitive, but the Commission is not required to take this step even when it finds that effective competition is present.

We recommend competitive classification of ILEC residential bundles because this action will invoke consumer and competitive safeguards that do not apply to non-competitive services. It may seem counter-intuitive to suggest that lifting price regulation by the UTC would actually increase consumer protection, but Staff believes that this is the case. As the discussion below illustrates, the Legislature has recognized the potential for abuse by a company that provides both competitive and non-competitive services and has adopted several provisions to prevent that abuse. They are not available, however, if the UTC allows a competitive service to remain in the ILEC tariff as a regulated, non-competitive service.

1. Protections for consumers of ILEC bundles
  - a. Application of the state Consumer Protection Act

Competitive classification of ILEC bundles will extend to consumers the protections of the state's Consumer Protection Act (Chapter 19.86 RCW). Here is how the Attorney General explains the Consumer Protection Act:

Washington's Consumer Protection Act declares that unfair and deceptive practices in trade or commerce that harm the public interest are illegal. The law gives the Attorney General's Office the authority to bring lawsuits against businesses, and to ask the court for injunctions and restitution for consumers. The law also allows individuals to hire their own attorneys to bring consumer protection lawsuits. If the consumer wins in court, the law allows the court to award triple damages, up to \$10,000, as well as attorney's fees.

However, the Consumer Protection Act includes an exception for services regulated by the UTC (RCW 19.86.170). The Legislature then adopted an exception to that exception, which provides that a service that is classified as competitive by the UTC is subject to the Consumer Protection Act (RCW 80.36.360).

Classifying the ILEC residential bundles as competitive will cause those bundles to become subject to the Consumer Protection Act, thereby providing consumer protections that do not exist today. The UTC could, at least in theory, adopt consumer protection standards prohibiting the same sort of unfair and deceptive practices that are outlawed by the Consumer Protection Act, but even if it did so the remedies available to consumers would be inferior, because the UTC cannot award damages, triple damages, or attorney's fees to a consumer who successfully brought a consumer protection claim under the UTC statutes.

b. Removal of the filed rate doctrine

A second way in which competitive classification increases consumer protection is through removal of the filed rate doctrine. The filed rate doctrine is a legal principle that requires regulated utilities to charge only the prices stated in their tariff. Courts assume those prices are reasonable because they are approved by regulators. Consumers should be able to rely on the price claims made in advertisements, but the filed rate doctrine may enable companies to impose charges or conditions on a customer by including them in a tariff. Competitive classification will establish that the UTC does not actively supervise the prices and terms of ILEC bundles. As a result, it will be easier for customers to hold companies to the offers made in advertisements and other marketing material.

c. Consistent application of legal standards

Finally, competitive classification will help customers of ILEC bundles by putting all packaged offerings under the same legal standards. Today the Consumer Protection Act applies to some packages and not to others, depending on the regulatory status of the company. Even within a single group of offerings, the legal standards today differ in a way that consumers cannot be expected to understand.

It should be noted that competitive classification of ILEC bundles would not entirely unify the processes that consumers use to resolve disputes about their telecom services. The ILEC bundles – like the packaged offerings of MCI and other competitive local exchange companies – would be classified as competitive but still subject to regulation. The UTC rules that protect consumers from inaccurate bills, unauthorized charges and changes in service, and inadequate service quality would still apply. The UTC would provide informal dispute resolution services to customers of the ILEC bundles. The UTC's consumer rules do not apply to unregulated services, such as Internet phone providers, wireless providers, and even Comcast's Digital Voice service.

2. Protections for consumers of non-competitive services

Competitive classification of ILEC bundles also would invoke statutory provisions designed to protect the customers of non-competitive services from cross-subsidy of the competitive services. RCW 80.36.330(6) provides:

(6) No losses incurred by a telecommunications company in the provision of competitive services may be recovered through rates for noncompetitive services. The commission may order refunds or credits to any class of subscribers to a noncompetitive telecommunications service which has paid excessive rates because of below cost pricing of competitive telecommunications services.

If the ILECs incur losses on their residential bundles, they will be legally prohibited from raising rates for non-competitive services to offset those losses. They also could be required to pay refunds to customers of non-competitive services. As long as the bundles remain classified as non-competitive, that statutory provision does not apply.<sup>8</sup>

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<sup>8</sup> It would be possible for the UTC, as a matter of policy, to decide that it was inappropriate or unreasonable to raise rates for basic service to offset losses on bundled services, but the absence of a competitive classification would make that argument harder to sustain. Staff is aware of no statutory

Competitive classification of ILEC bundles also protects customers of non-competitive services by invoking the provision in RCW 80.36.330 prohibiting below-cost pricing:

- (3) Prices or rates charged for competitive telecommunications services shall cover their cost.

There is no comparable statute that prevents a telecommunications company from pricing a non-competitive service below its cost. The UTC can, as a matter of policy, decide that some or all prices for non-competitive rates should be priced above cost,<sup>9</sup> but the law requires that result only if the service is classified as competitive.

Customers of non-competitive services are protected in yet another way through the application of a provision in the contract statute, RCW 80.36.150:

- (5) If a contract covers competitive and noncompetitive services, the noncompetitive services shall be unbundled and priced separately from all other services and facilities in the contract. Such noncompetitive services shall be made available to all purchasers under the same or substantially the same circumstances at the same rate, terms, and conditions.

This provision is designed to prevent a company from using a customer contract to offering a non-competitive service to one customer at a more favorable price than it offers to other, similarly situated customers. It does so by requiring that the non-competitive services be separately stated and made separately available to other customers. It does not, however, prevent a company from tying two services if neither has been classified as competitive.

### 3. Protections for competitors of the ILECs

Finally, classification of ILEC bundles as competitive invokes competitive protections that would otherwise not apply or, at best, would be policy considerations for the UTC. The Consumer Protection Act, despite its name, also protects competitors. It declares as unlawful unfair methods of competition, restraint of trade, and attempts to monopolize

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provision that would authorize the UTC to order refunds when the unprofitable service has not been classified as competitive.

<sup>9</sup> The UTC adopted a policy of requiring that regulated rates cover cost in Docket UT-950200. However, this decision applied only to the company whose rates were being established in that proceeding (Qwest, then know as U S WEST). It has not established a general requirement that regulated rates for individual services cover the cost of each service.

to be unlawful. It prohibits firms from fixing prices or prohibiting the resale of their services. The ability to resell a competitor's service can be an important part of a telecommunications company's business plan, particularly when it is entering the market.

The Consumer Protection Act provides another, indirect protection to competitors by deterring its competitors from engaging in deceptive practices. A firm that accurately discloses its prices and stands behind its products will be at a competitive disadvantage if other firms in the same market are free to engage in false advertising and other deceptive practices. The Consumer Protection Act protects firms that want to be honest and accurate by reducing the possibility that they will be undercut by less scrupulous competitors.

Staff does not intend to disparage the conduct of any specific telecommunications company, but we believe that protection of competitors is an important reason for the UTC to classify ILEC bundles as competitive. Staff is concerned that the ILECs currently are actively participating in a competitive market in which their competitors are subject to the Consumer Protection Act while they are not. For example, we have been concerned that the advertising for local service packages often does not accurately represent the total price of the advertised package. This concern applies both to the ILEC's advertising of their packages and the unregulated providers' advertising of their packages. The ILECs may feel less need to make a full disclosure of package prices because they are exempt from the Consumer Protection Act, and their competitors may feel the need to follow suit in order to avoid losing customers to a competitor advertising a lower price.

#### G. Conclusion

Staff believes that the ILEC residential packaged services are subject to effective competition. Customers subscribing to these services have reasonable alternatives in the form of comparable offerings from other providers and purchase of identical services from the ILEC's regulated tariff. These consumers will have more protection from deceptive advertising practices and other potential abuses if the UTC declares the services to be competitive. This action will also help protect competition by ensuring that ILECs are held to the same legal standards as their competitors.